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SECRETARY, BOARD OF
OIL, GAS & MINING

MEMORANDUM

September 12, 2016

To: Utah Board of Oil Gas and Mining

From: Steve Alder, 
Assistant Utah Attorney General

Re: September 28, 2016 Board Hearing Memorandum
In the Matter of:
Axia Energy II, LLC; Docket No. 2016-017, Cause No. 139-139

I. Introduction

Axia Energy II, LLC (Axia) is seeking an order of the Utah Board of Oil, Gas, and Mining (Board) pursuant to Utah Code §40-6-6.5 to compulsively pool the interests of non-consenting owners for two long horizontal wells in two recently approved drilling units. In addition, Axia is asking that the Board's order be applicable to all future wells in each drilling unit provided Axia provides notice of a future well with costs and the interest owner fails to lease or agree to participate in the future well.

One consequence of the success of drilling long horizontal wells has been the establishment of larger drilling units for such horizontal wells and simultaneous authorization of many wells per drilling unit. The Division acknowledges that one additional consequence of such spacing orders, is an increase in the economic costs and administrative burden of force pooling many owners in many wells. This burden is offset to some degree by the advantages of larger drilling units. Regardless of the relative advantages or disadvantages, the Utah statutory provisions governing forced pooling and the cases interpreting those provisions must be satisfied. This Memorandum addresses the questions regarding whether Axia's Request for Agency Action (RAA) can satisfy those requirements.

Regarding the compulsory pooling of the two identified wells, the Division believes the RAA is complete, but will await full presentation of the testimony and evidence to be provided at the hearing to be assured that it satisfies the statutory requirements.

II. Axia's Request for Agency Action, Utah's Pooling Statute and Utah Case law.

A. Axia's Request.

Axia has proposed and commenced drilling two long lateral horizontal wells: the Butcher Butte 32-144H-21 well in drilling unit 29/32 consisting of sections 29, and 32, T2S R1W, USB; and the Butcher Butte 33-34H-21 well proposed for unit 28/33

consisting of sections 28 and 33, T2S R1W, USM. Axia asks the Utah Board of Oil, Gas, and Mining to enter an Order that would pool the mineral interests in the drilling units of identified owners who have not consented to pay their share of the costs of the two wells. Axia has submitted the costs of drilling, an Operating Agreement, and other information required by the statute.

Axia also asks that the order from this hearing apply to future wells, not yet identified as to location or type, “upon the satisfaction of the following” conditions: (1) Axia must before drilling “give notice of its intent to drill a Future Well, estimated costs, and invite each interest owner to participate in the Future Well subject to the terms of this Order”; (2) Axia must “provide each interest owner at least 30 days to respond”; and (3) “[I]f an interest owner fails to timely respond or refuses to either lease or participate in the Future Well then the interest owner shall be considered a Non-Consenting Owner for the noticed well” and be subject to the Order in this matter. There is not proposed provision that would require or provide an opportunity for an additional hearing

B. Utah’s Pooling Statute and Rules.

The language of the Utah pooling statute allows that “[I]n the absence of a written agreement for pooling, the board may enter an order pooling *all interests in the drilling unit.*” (Utah Code § 40-6-6.5(2)(a) (emphasis added)). The statute also provides that the interest owner must be provided written notice to and an opportunity to consent in advance to bear his proportionate costs of the drilling and operation of a well in order to be found non-consenting. (Utah Code §§ 40-6-2(4) and (11)). This statutory language is specific to the costs for “a well.” The Board must also make additional findings. These include adopting terms and conditions for an operating agreement that are just and reasonable (§ 40-6-6.5(2)(b)); determining that the proposed costs of drilling and operating the well are just and reasonable (§ 40-6-6.5(4)(a)(i)); determining the royalty attributed and to be paid to the non-consenting owners based on average royalty prior to drilling that interest (§ 40-6-6.5(6)); determining an estimated cost of plugging the well (§ 40-6-6.5(4)(d)(i) (B)); and determining the appropriate non-consent penalty of 150% to 400% of identified costs to be applied against the production from the non-consenting owners (§ 40-6-6.5(4)(d)(i)(D)).

In addition to the requirement of the statute, there are specific rules that govern non-consent findings. These rules provide that an operator must have attempted “in good faith to reach an agreement with the owner for leasing or for voluntary participation in the well *prior to filing of a Request for Agency Action*”. (R649-2-9(2)) (emphasis added) The rule goes on to allow (upon written request and notice and hearing), “for the hearing on the Request for Agency Action may be delayed for up to 30 days to allow for negotiations. Thus, the rule assumes that it is necessary to file a RAA and hold a hearing for each owner prior to involuntarily pooling the interests.

C. Utah Case Law.

Utah's Oil and Gas Conservation Act has been interpreted by the Utah court over the years in a manner that has generally been protective of the rights of owners of oil and gas interests and might be pooled without their consent. The Court has found that due to the limitations of the drilling of additional wells once a drilling unit has been approved, that "a non-consenting mineral owner had a vested right to a royalty prior to payout, and a vested right to his statutory share (subject to payment of expenses) thereafter." *Bennion v. Utah Board of Oil, Gas and Mining*, 675 P.2d 1135, at 1142 (1983). The court noted that these vested rights must be compensated to prevent the regulatory legislation from unconstitutionally depriving the nonconsenting mineral owner of his property without compensation. *Id.*

Because rights of an owner are vested property rights there must also be due process protections afforded the interest owner prior to the compulsory pooling and potential imposition of the non-consent penalty. Due process requires notice and opportunity for a hearing. Utah Administrative Procedures Act (Utah Code §§ 63G-4-101 to 601); *see* Utah code § 40-6-10 (1)(a) (2013); Utah Admin. Code Rule R641-100-500; *Hegarty v. Board of Oil, Gas and Mining*, 57 P.3d 1042, 1048-9 (2002).

The type of notice required prior to determining if an owner is non-consent must be a "written notice sufficient to trigger the necessity for consent and sharing of costs in a specific well impacting a landowner's tract." *Hegarty v. Board of Oil, Gas and Mining*, 57 P. 3d 1042, 1049 (2002).

III. Analysis.

Axia's RAA raises at least two main questions: (A) Is it possible for the Board to have one hearing and make the determinations required by the pooling statute to approve pooling for future wells conditional on the operator to complying with certain conditions as to notice and consent?; (B) Can the Board satisfy the due process requirements for pooling with an order that is conditional on future notice and opportunity to consent to participate or lease?

A. Is it possible for the Board to have one hearing and make the determinations required by the pooling statute for future wells by conditioning the operator to comply with certain notice and consent conditions?

All of the conditions or findings required by the statute prior to approving a pooling agreement and imposing a non-consent penalty must be determined by the Board. It is implicit in the structure of the Board's adjudicative process for making such determinations that their the decision must occur after there has been a hearing that was noticed and scheduled for that purpose. *See* Rules of Practice and Procedures before the Board of Oil Gas, and Mining, Utah Admin. Code R641-100 to R641-119 (2016). The first question posed by the RAA is if one hearing can suffice for the Board to make these

determinations or if the board must have another hearing to make the findings for each well?

It is hard to imagine how an Order of the Board can properly determine the required terms of that Order in advance of the time that a well is proposed.. If there are to be 32 wells in a drilling unit, it is reasonable to expect that the drilling will extend for a period of many years even if the drilling continues without delay. It may be longer if leases are held by production and other opportunities are more attractive. Due to the passage of time and potential for additional leasing, the royalty rate most likely will need to be recalculated. The estimated costs of plugging may have changed and will need to be re-determined. The reasonableness of the AFE or estimated costs of drilling which may be an issue in whether there a reasonable offer, may have changed and be subject to reconsideration.

Perhaps most importantly, the factors that affect how the Board should impose one non-consent penalty will not be the same for all future wells in the entire drilling unit. The risk of success may change for each well, both as experience improves success, but also as drilling begins in the different zones or formations to be produced or for different geographic sections of the drilling unit. Success and risk may also vary for different types of wells such as vertical rather than short or long horizontal wells.

Arguably there could be one order that addresses these issues for the entire drilling unit with terms and conditions to be binding on the operator or the Division. However, such as Order would in effect result in delegating the Board's duty to make these finding to the operator. Due to the potentially punitive nature of compulsory pooling and the increased scrutiny required to affect a property right, it is the Division's belief that such an order would not be reasonable or appropriate. The Board should not structure an order that would determine the fair and reasonable terms and conditions of a pooling agreement and order for future wells at the hearing and order for the pooling of the first well.

B. Can the Board satisfy the due process requirements for pooling with an order that is conditional on future notice and opportunity to consent to participate or lease?

For the Board to take any action it must have a quorum and comply with the Utah Administrative Procedures Act (UAPA; Utah Code §§ 63G-4-101 to 503). The UAPA applies to any "state action that determines the legal rights, duties, privileges immunities or other legal interests of an identifiable person" 63G-4-102(1). Since a pooling order must identify the person whose interests are being pooled, that person is entitled to the protections of UAPA. These protections include notice of the agency action being provided in accordance with §§ 63G-4-201(1) to (7).

The courts have interpreted the due process requirements under the UAPA to vary depending on the degree to which the administrative decision is adjudicative. Stricter and

more specific due process requirements apply to adversarial, adjudicative decision-making by administrative agencies, “the most fundamental requirement in this context is the opportunity to be heard at a meaningful time and in a meaningful manner, and necessary corollary to that opportunity is that the affected parties must be assured that their concerns will be heard by an impartial decision maker.” *V-1 Oil co. v. Department of Environmental Quality*, 939 P.2d 1192 at 1197 (1997). It would be contrary to this requirement for the Board to in effect delegate to the Operator the ability to determine if notice has been given, and if the interest owner had timely consented. At the very least any such order would require a provision that would provide the interest owner the right to appeal to the Board such issues as notice and consent, even if other terms were imposed by the original order. Axia’s RAA does not propose such a provision and it is unclear how that would be accomplished.

The inherent structure of the Act and rules assumes that for each forced pooling order, there will have been a RAA filed and a hearing if the interest owners don’t consent after there has been notice and a good faith attempt to reach an agreement. The language of R649-2-9(2) is clear that the owner is to have notice and the opportunity to continue the hearing if there has not been thirty days’ notice and good faith negotiations. This rule could not be satisfied prior to a well being identified and must apply to each owner. Ultimately it requires the opportunity for a hearing.

IV. Conclusion.

An order that would allow force pooling of future wells on the condition of the operator providing evidence of notice and opportunity to consent (or not) at a future date is not appropriate. It is not sufficient to satisfy the required notice and opportunity for hearing that is mandated by UAPA. It is inconsistent with the Board’s rules, and it is contrary to the fair and reasonable requirements of the statute. Any fair reading of the statute requires that the Board make the required findings for each well and that each owner shall have the opportunity to present his grievances to an impartial Board.

Admittedly it is difficult and expensive in some cases to determine who is an owner and to make a reasonable effort to provide notice and negotiate in good faith. However, determining if there has been an adequate effort prior to imposing penalties at the very least requires that the operator present his evidence to the Board and that an owner who objects have an opportunity to have a hearing before the impartial Board. The order should not allow such issues to be decided by a party with an interest in the outcome.

CERTIFICATE OF SERVICE

I hereby certify that on this 15th day of September, 2016, I caused a true and correct copy of the foregoing **Memorandum** for Docket No. 2016-017 Cause No. 139-139, to be mailed by Email or via First Class Mail with postage prepaid, to the following:

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A handwritten signature in blue ink, appearing to read "Julie A. Cant", is written over a horizontal line.